Supreme Court of the United States

No. 482

IN THE

Supreme Court of the United States

October Term, 1960

TENNESSEE LIFE INSURANCE COMPANY, *Petitioner*

v.

R. L. PHINNEY, District Director of Internal Revenue at Austin, Texas, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY OF PETITIONER TO RESPONDENT'S BRIEF IN OPPOSITION

Argument

This case stands for the proper determination of "true net income" as between related taxpayers. If such "true net income" is to mean merely what the Commissioner of Internal Revenue shall say that it means in each case, then this case may be one of little importance. If on the other hand the restraint of a standard is to be imposed upon the

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Commissioner in the determination of such "true net income", then in its departure from such a standard this is a landmark case.

An appropriate summation of the purpose and intended extent of Sec. 45 of the Internal Revenue Code of 1939 (now Sec. 482, Internal Revenue Code of 1954) is found in the last sentence of Regs. 118, § 39.45-1. That concluding sentence reads as follows:

> "The authority to determine true net income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

Within that sentence may be found the rationale for the exercise of authority under Sec. 45, and the heretofore supposed limitations upon that exercise. The failure of the respondent to recognize this inherent standard in the application of Sec. 45 lies at the bottom of the entirety of the brief respondent has filed in this proceeding.

1. Respondent asserts that the decision below is not in conflict with *Magruder v. Supplee*, 316 U.S. 394 (1942). The purchaser who there acquired the properties and paid the advalorem taxes thereon after the date such taxes became a lien and the personal liability of his seller was in no sense related to the seller. The denial by this Court to that purchaser of a deduction for the taxes *fixed the standard* applicable to unrelated parties dealing at arm's length in a case involving ad valorem taxes. In prior cases reaching the same result as that reached by *Magruder v. Supplee*, that arm's length standard was held to be con-

trolling, even in cases involving a close relationship between the parties. In *Merchants Bank Building Co. v. Helvering*, 84 F. 2d 478 (8th Cir., 1936), after the taxes became a lien and the liability of the transferor, the property was transferred by the transferor corporation to another corporation in exchange for *all* of the capital stock of the latter, all pursuant to a tax free reorganization. Because the transaction was one between controlled taxpayers pursuant to a reorganization, it was argued that the ordinary rule denying a deduction for ad valorem taxes to a person other than the owner of the property on the lien date should not be applied. Holding for the Commissioner that the corporation which received the properties pursuant to the reorganization exchange was not entitled to any deduction for the taxes in question, the Court stated (p. 481):

> "Whether the transaction be called a sale, exchange, barter, or be given some other name, is not a matter of primary importance. Manifestly, the act did not have the effect of changing the inherent nature of the transaction. Viewing the transaction as a sale or exchange of property, the question in the final analysis is as to the right of a grantee to deduct as expenses taxes which he pays, but which were liens upon the property at the time of the transfer."

Closely related parties and tax-free transactions were similarly before the Court in the cases of *American Liberty Oil Co. v. Comm'r.*, 43 BTA 76, and *Texas Coca Cola Bottling Co. v. Comm'r.*, 30 BTA 736, cited and argued in petitioner's application for certiorari herein. The same result was reached in the case of *Brudno v. Comm'r.*, 138 F. 2d 770 (6th Cir., 1943), cited at page 645 in *Simon J. Murphy Co. v. Comm'r.*, 231 F. 2d 639 (6th Cir., 1956). In that case the Commissioner denied a deduction to a con-

trolling shareholder for any part of the current ad valorem taxes which such shareholder paid on properties which the controlled corporation distributed to him in liquidation after the taxes became a lien and the personal liability of such controlled corporation.

If the Courts shall now say that adherence to this standard of arm's length conduct between uncontrolled taxpayers is not required in a transaction between controlled taxpayers, then there is no conflict here between the decision below and that of *Magruder v. Supplee*; but if adherence to that standard is to be maintained, conflict between the decision below and the decision of this Court which fixed the nature of the arm's length standard in regard to the deductibility of the ad valorem taxes is inescapable.

2. The same circumstance is true regarding the conflict between the decision of the Court below and that in the *Murphy Co.* case as to the accrual date for ad valorem taxes. If the standard of arm's length conduct is to be applied, then the taxes may be accrued only by the party who owned the property on the date the taxes became a lien and the personal liability of such party. If such taxpayer together with the separate taxpayer with whom it is associated in control is to be considered as one taxpayer for purposes of the accrual, then the arm's length standard will have been abrogated.

The distortion to which the respondent refers in admitting the conflict between the decision of the Court below and that of the Sixth Circuit in the *Murphy* case does not exist if the arm's length standard is to be followed. That standard denies any deduction for taxes to a subsequent owner regardless of the effect of such denial on taxable income. If distortion exists in permitting Building

Corporation to take a deduction for the entirety of the taxes during its short year 1953, it is because a standard of "true net income" *other than that* of arm's length conduct between uncontrolled taxpayers is being applied to determine the meaning of true net income.

Obviously collusive conduct was not involved in the *Murphy Co.* case. The Court there stated, (p. 645), "In the present case the transaction was a bona fide one". We believe it is fair to assume the Court below in the instant case so viewed the transaction at bar.[1] In referring to the bona fides of the transaction, we do not in any sense suggest that a collusive intent is a prerequisite to the allocation of income or deductions under Sec. 45. Our position is simply that, where such an intent may appear, there may be more reason to ask whether things are what they seem. It was in such context that the Court in the *Murphy Co.* case stated (p. 645) that collusive conduct was "necessary" to permit the Commissioner, not as alleged by respondent in its brief (p. 9) to make an allocation under Section 45, but "to make an allocation of net income different from what was *properly and legally* reflected by the books". The result which was "properly and legally reflected by the books" in the *Murphy Co.* case was simply the application to the facts there involved of the arm's length standard of conduct between uncontrolled parties applicable to those facts.

3. The importance of this case is simply whether a standard of arm's length conduct is to be adhered to in transactions between controlled taxpayers, or whether a-

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[1] See statement (Pet. 37) of Judge Cameron, dissenting, stating that "There is no contention that the transaction here involved was not bona fide in every respect and that it did not serve a useful purpose"

the Court below stated "On the broader ground, we are satisfied that the right of the Commissioner to apportion or distribute deductions or income under Sec. 45 is not restricted to such apportioning or distribution as would be permissible for two unrelated taxpayers under existing taxing statutes." Put more simply is "true net income" to be in each case what the Commissioner says it is to be, or is there to be superimposed the restraint of some appropriate standard on what the Commissioner may say "true net income" is to be.

The standard here sought was imposed in each prior case in which deductibility of taxes as between related parties was considered. Certain it is that the Commissioner in each such case was arguing the applicability of that standard. But if faith of the taxpayers generally in the system, which is conceded to be a prerequisite to the continued success of our revenue system, is to be maintained, then the Commissioner should not be allowed to insist on the standard when it is to his benefit and depart from it in those instances in which he conceives the immediate tax result to be detrimental to the revenues.

The respondent then finally argues that adherence to the standard here urged is in any event not pragmatically important because a question will only infrequently arise on the facts at bar. This argument begs the principle, but nevertheless let it be examined. The exact question will arise each time there is an exchange or a distribution of property which does not amount to a *sale* of such property.

Where the Internal Revenue Code of 1954 is applicable Sec. 164 (d)(1) of that Code permits apportionment of ad valorem taxes on realty between sellers and purchasers, but under the terms of such statute such apportionment is limited to circumstances where the realty is *sold*. Simi-

larly, Sec. 461 (c) of the 1954 Code is of no benefit to a party acquiring property after the taxes thereon become a lien and the personal liability of the prior owner. That section permitting accrual of real property taxes over the period to which they relate is specific in its allowance of such privilege only to a person who "incurs" real property taxes. This Court in *Magruder v. Supplee* (at pp. 398 and 399) made it clear that no "taxes" were *incurred* by a subsequent owner taking the property after the taxes became a lien and the personal liability of a predecessor in title. It is for that reason that sub-paragraph (B) of Sec. 164 (d) (1) became necessary so as to treat expressly the portion of the taxes allocable to the period during which the property is held by the purchaser as being taxes "imposed on the purchaser". No similar language occurs in Sec. 461 (c) which would alleviate the limitation of that section to one who "incurs" the taxes.

Further, it is not true that (Res. Br. p. 10), "the standard cannot properly be applied to give to related enterprises a tax treatment which would be accorded to independent entities dealing at arm's length (because) the nature of the transaction is one peculiar to related corporations so that there is in fact no comparable factual situation between (un)related corporations."

It not infrequently occurs that a minority stock interest, being in no sense "a controlling interest" is liquidated by a distribution of property in exchange for the surrender for cancellation of the stock of that minority holder. Under *Magruder v. Supplee*, that former minority stockholder will not be entitled to claim any deduction for taxes on the distributed property for which a lien and liability had affixed prior to the date of distribution. It also not infrequently happens that acquisition of corporate properti

is obtained through purchase of the capital stock of a pr corporate owner and immediate distribution thereafter its properties in liquidation. Such a transaction would no sense represent one between controlled taxpayers, be under *Magruder v. Supplee*, the acquiring corporate own could secure no deduction for taxes it might pay on th properties distributed in liquidation after a lien and li bility for the taxes thereon had been affixed. And, as hereinabove shown the standard of *Magruder v. Supplee* has bee applied in all cases of non-taxable exchanges between re lated taxpayers. The standard to which petitioner reques adherence is a *true* standard.

Conclusion

Petitioner respectfully submits that this case presents significant question in regard to the administration of th revenue laws as between controlled taxpayers, and that th question is one which this Court has not considered. Petitioner respectfully submits that "on the broader front" the orderly administration of the revenue laws demand that the Commissioner as well as taxpayers adhere to standard in the determination of taxable income.

Respectfully submitted,

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November, 1960

Certificate of Service

I hereby certify that I have this day in the manner hereinbelow stated served each of the following persons with a copy of this Reply of Petitioner, as required under Paragraph 2 of Rule 33.

1. Solicitor General, Department of Justice, Washington 25, D. C., by United States Airmail deposited at Houston Texas.
2. Hon. Charles K. Rice, Assistant Attorney General, Department of Justice, Washington 25, D. C., by United States Airmail deposited at Houston, Texas.
3. Hon. Russell B. Wine, United States Attorney, Western District of Texas, San Antonio, Texas, by United States Airmail deposited at Houston, Texas.

Dated this ____day of November, 1960.

ROBERT K. JEWETT
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